

TABLE IX-4. BUDGET SAVINGS FROM FINANCIAL,
INFORMATIONAL, AND SUPPORT SERVICE USER
FEES SET TO RECOVER FULL FEDERAL COSTS
(In millions of dollars)

Services	1984	1985	1986	1987	1988	Cumulative Five-Year Total
Postal Service	740	778	815	849	882	4,064
Patent and Trademark	8	8	8	9	9	42
Charts and Maps	44	44	44	44	44	220
Space Shuttle	73	237	394	373	303	1,380
Tax Rulings and Determinations	13	13	14	15	15	70
Total	878	1,080	1,275	1,290	1,253	5,776

be identified and charged for the costs incurred by the federal government. Several examples of federal services for which existing fees could be increased, or new fees imposed, are examined below.

U.S. Postal Service. The U.S. Postal Service is basically a self-supporting enterprise, with the exception of two major categories of service for which federal appropriations have been provided. The first category covers public service operations that are not remunerative but judged to be in the national public interest, such as postal facilities in remote areas and Saturday mail delivery. The second category, conceived to promote the flow of news, educational, charitable, and cultural materials, covers reduced-cost mail for several groups of users. This category includes low-rate service for handicapped persons, for religious and other not-for-profit organizations, for small-circulation newspapers, and for libraries. Payments for the latter services are termed "revenue forgone" subsidies. (Chapter VIII considers other aspects of federal subsidies to the Postal Service.)

Originally, the public service payment was authorized at 10 percent of the Postal Service's 1971 budget, or \$920 million. The Postal Reorganization Act of 1970 provided that this subsidy would continue at \$920 million until 1980, when it would begin to be reduced by 10 percent yearly until reaching \$460 million in 1984. Past and current Administrations have significantly speeded up the reduction in this subsidy, however, and the

Congress provided only \$12 million for public service costs in 1982. No funds for this subsidy have been provided to date for 1983, although the Appropriations Committees provided language (in Senate Report 97-547) requiring the Postal Service to maintain current levels of service and to retain small post offices. The language also provides that the subsidy may be restored at a later date.

The revenue forgone subsidies are of two sorts--a "phasing" appropriation and a "continuing" appropriation. The phasing appropriation for revenue forgone was intended to provide gradual reductions in postal rate subsidies. The continuing appropriation permanently authorizes U.S. Treasury funding of a rate differential benefiting all categories of preferred mailers. Essentially, the preferred mailer is not asked to contribute through postal rates to the fixed overhead costs of postal service. The taxpayer makes up the difference between what the preferred mailer pays and what the commercial rate would be for the same piece of mail. For 1983, the Congress appropriated \$789 million for revenue forgone subsidies (including both phasing and continuing appropriations).

If the federal government eliminated all revenue forgone appropriations (except those supporting free mail for the blind and handicapped), the savings in 1984 would total \$740 million. Savings for 1984-1988 would total \$4.1 billion (see Table IX-4). These reductions in federal subsidies would be accompanied by rate increases, particularly for preferential mail.

Patent and Trademark Registration. The Patent and Trademark Office of the Commerce Department provides special benefits, beyond those accruing to business and industry, to individuals who obtain patent protection for inventions and trademark registration. Patent protection affords a 17-year monopoly giving the patent holder exclusive rights to returns from commercial application of the invention.

Each year, the Patent and Trademark Office receives more than 100,000 patent applications and more than 50,000 applications for trademarks. The costs to the federal government of processing these applications were about \$90 million in 1982. Some of these costs--about \$28.5 million in 1982--were offset by receipts from patent and trademark application fees. Public Law 97-247, (Patent and Trademark Office Appropriation Authorization), signed August 27, 1982, increased these fees so that all costs (except those incurred in servicing small businesses, individuals, and universities) would be recovered over 17 years--the life of the patent. Fees for small businesses, individuals, and universities are limited to half of full cost recovery. If, in a departure from current policy, fees were increased to recover 100 percent of costs for all users, receipts to the

federal government would increase by about \$8 million in 1984 and \$42 million over the 1984-1988 period (see Table IX-4).

Charts and Maps. The National Oceanic and Atmospheric Administration, an office of the Department of Commerce, prepares aeronautical charts and nautical maps for use in aviation and maritime activities. The federal government will spend about \$70 million on mapping and charting services in 1983. About a third of these costs--or \$26 million--will be recovered from current user fees.

This subsidy could be completely offset by raising the purchase prices of maps and charts. Current charges now average about \$2 for aeronautical charts and \$5 for nautical maps. If these charges were increased to \$9 and \$37 respectively, the federal government could recover the full cost of the mapping and charting program. Although these charges would represent a large increase over current levels, they would remain only a small portion of the overall costs of operating aircraft or marine vessels. Full-cost recovery would increase federal receipts by \$44 million in 1984 and \$220 million during the 1984-1988 period (see Table IX-4).

Income Tax Rulings and Determinations. Upon request from a private firm or organization, the Internal Revenue Service (IRS) provides income tax rulings and determinations. Tax rulings are prepared by the IRS when a given firm or organization requests a ruling on particular points of tax law. Determination letters are prepared to establish the requestor's tax-exempt status or its eligibility as a pension trust plan organization. In 1982, the IRS received 215,072 requests for such rulings and determinations. Some 159,400 requests involved letters of determination or rulings on pension trust plan organizations, while 55,672 sought determinations on tax exemptions. In addition, 30,555 preliminary rulings on accounting periods and methods were requested by individuals and accounting firms. Such requests for preliminary tax rulings and determination letters are likely to increase significantly in the near future because of the recent changes in tax law enacted last year under TEFRA.

The tax rulings and determinations process has imposed large demands on government resources; the cost of this service was estimated at about \$31 million in 1982. The costs associated with requests for letters of determination and rulings from tax exempt organizations were funded, however, from a 2 percent excise tax on private foundations, thereby reducing the government's net cost to \$23 million. Given the sizable cost of this service to the government and the financial benefits that requesting firms and organizations stand to realize, the IRS could charge a fee to recover some or all of the costs of rulings and determinations not now funded from the 2 percent excise tax. Such fees would offset federal

expenditures for this service, while doubtless also discouraging some of the demand and thereby forestalling backlogs and delays. If charges were instituted to recover 50 percent of the federal cost of providing these rulings and determinations (requiring a charge of about \$60 per applications), additional collections during 1984 would total about \$12.8 million. Any future increase in the number of applications or in the government's cost for this service would result in higher future collections.

Space Shuttle. The National Aeronautics and Space Administration (NASA) launches satellites both for military purposes and for commercial use. NASA is expected to use the space shuttle for most future satellite launchings. Firms currently pay NASA for launching their satellites, but NASA has set charges below the full federal cost of this service. Such undercharges stem from several factors. First, some of the launching charges were originally set several years ago, when estimates of the costs for the shuttle program were more optimistic than they are now. Prices have not been revised upward, however, though cost estimates for the shuttle program have risen. Second, no attempt has been made to recover the research and development costs associated with the shuttle program, estimated at about \$15.3 billion over the last 12 years. And third, NASA appears to want to maintain relatively low user charges in order to encourage maximum use of the space shuttle.

Rate increases for commercial satellite launchings by the space shuttle seem appropriate, since the clear beneficiary is private industry. Rate increases for NASA's commercial launchings may be constrained, however, by the availability of traditional rocket launchers. (A consortium of European countries is likely to follow NASA's price lead.) Nevertheless, the current charges of \$21 million for launching a typical communications satellite in 1986 could probably be increased by about 60 percent without risking losses in revenues. These charges would not include recovery of research and development expenses and, because of existing contracts, could not be applied to launches before 1986. Such increases would generate total additional collections of about \$1.4 billion over the 1984-1988 period.

Regulatory Oversight

The federal government undertakes a variety of regulatory oversight activities. These range from financial and economic regulation (such as that carried out by the Securities and Exchange Commission and the Commodity Futures Trading Commission) to environmental and natural resource regulation (as carried out by the Environmental Protection Agency). For the most part, these activities or services are not currently subject to user fees. In 1983, only \$.3 billion will be collected in user fees levied in this area.

Application of the user fee principle to federal regulatory oversight activities could be contentious. On the one hand, it can be argued that the federal government's regulatory oversight activities grew out of a concern for the public's interest and are intended to protect the public; hence, the cost of these activities should be paid by the public. On the other hand, it can be argued that the regulated industries or markets should bear the cost of federal regulation--because they are placing the public at risk through their activities, or because, as market participants, they either benefit directly from the regulatory activities or have the ability to pass along the costs of regulation to the direct beneficiaries, their consumers. To the extent that the Congress favors the latter argument, federal expenditures for a variety of regulatory oversight activities could be recouped from user fees. A couple of areas in which such fees might be levied are examined below.

Federal Energy Regulatory Commission. The Federal Energy Regulatory Commission, an independent body within the Department of Energy, regulates oil pipelines, licenses hydroelectric power projects, and regulates the rates and service standards for wholesale electric sales in interstate commerce. The commission also has jurisdiction over interstate aspects of the natural gas industry, as well as regulatory control over intrastate producer sales of natural gas.

Federal outlays for the commission will total about \$80 million in 1983. Approximately one-half of these costs--or \$42 million--are expected to be offset by revenues from the commission's existing and planned fees for pipeline approvals and hydropower licenses. If these existing fees were increased further, offsetting receipts could finance the commission's total costs. The federal savings would be \$37 million in 1984 and about \$192 million over the 1984-1988 period (see Table IX-5).

Commodity Futures Trading Commission. The Commodity Futures Trading Commission, an independent regulatory agency, carries out the provisions of the Commodity Exchange Act of 1936. The purposes of the commission are to assure the efficiency and integrity of the futures market and to protect market participants against fraud, deception, and other abusive trade practices.

Federal outlays for the Commodity Futures Trading Commission will total about \$22 million in 1983. About \$1 million of these costs will be recovered in receipts collected from administrative fees for registration and informational services. If these fees were raised and new fees (such as transaction fees) instituted, offsetting receipts could be increased to fund the total costs of the commission. The federal savings would be \$23 million in 1984 and about \$122 million over the 1984-1988 period (see Table IX-5).

TABLE IX-5. BUDGET SAVINGS FROM REGULATORY OVERSIGHT
ACTIVITY USER FEES SET TO RECOVER FULL FEDERAL
COSTS (In millions of dollars)

Oversight Entity	1984	1985	1986	1987	1988	Cumulative Five-Year Savings
Federal Energy Regulatory Commission	37	38	38	39	40	192
Commodity Futures Trading Commission	<u>23</u>	<u>24</u>	<u>24</u>	<u>25</u>	<u>26</u>	<u>122</u>
Total	60	62	62	64	66	314

CONCLUDING COMMENTS

Broader application of user fees and other charges for federally provided services offers the potential for significant reductions in the budget deficit, while simultaneously promoting efficient investment. Budget receipts and offsetting receipts could be increased by as much as \$31 billion over the 1984-1988 period through such fees and charges (see Table IX-6). A large portion of these collections--about \$23 billion over five years--could be realized in the area of infrastructure construction, maintenance, and operation. Another \$5.8 billion in collections could be realized in financial, informational, and support programs. Other governmental undertakings offer significantly less potential for increased collections from user fees or other charges: some \$2.2 billion could be collected in the area of resource management, while fees for various federal regulatory activities examined here could increase collections by about \$.3 billion.

TABLE IX-6. SUMMARY OF BUDGET SAVINGS FROM USER FEES, BY
FEDERAL PROGRAM AREA (In billions of dollars)

Program Area	1984	1985	1986	1987	1988	Cumulative Five-Year Savings
Public Infrastructure	4.44	4.50	4.61	4.59	4.72	22.86
Resource Management	.37	.41	.46	.47	.48	2.20
Financial, Informational, and Support Services	.88	1.08	1.28	1.29	1.25	5.78
Regulatory Oversight	.06	.06	.06	.06	.07	.31
Total	5.75	6.05	6.41	6.41	6.52	31.15

CHAPTER X. REVENUES

Federal revenues as a percentage of the gross national product are projected to decline from a post-World War II high of 20.9 percent, reached in fiscal year 1981, to 18.3 percent by 1988. The projected decline is attributable primarily to the large multi-year individual and corporate income tax reductions enacted in the Economic Recovery Tax Act of 1981 (ERTA)--reductions that were offset, but only partly, by the increases enacted the next year in the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA).

Though federal taxes as a percentage of GNP during the 1984-1988 period are projected to decline to the levels that prevailed in the 1960s and 1970s, federal expenditures during the same period are projected to reach more than 24 percent of GNP if no additional spending reductions are made. The budget deficits that would result--5 to 6 percent of GNP--would be the highest since World War II.

These projected deficits led last year to a search for new ways to increase federal revenues, a search that is likely to continue this year. At the same time, the economy is in the longest and deepest recession since World War II. Increasing taxes during this recession could well make it worse and delay economic recovery. Even if tax increases are postponed until a recovery is under way, such increases could, if not carefully designed, inhibit long-term investment and economic growth. Any tax increases aimed at dealing with the long-term deficit problem should therefore be designed to minimize adverse effects on recovery and long-term growth.

Federal government revenues come principally from individual income taxes (currently about 47 percent of total revenues), social insurance taxes (about 35 percent), and corporate income taxes (about 7 percent). The remaining 11 percent comes from various sources, including excise taxes, estate and gift taxes, and user charges (see Table X-1). (User charges are considered in detail in Chapter IX.)

Certain provisions of the individual and corporate income taxes allow special tax reductions for some individuals and businesses, either to relieve hardships or to offer incentives for particular kinds of activities. Examples of such provisions, referred to as "tax expenditures," include the deduction for medical expenses and the investment tax credit for purchases of business

TABLE X-1. FEDERAL REVENUES, BY SOURCE

Revenue Source By Type of Tax	Actual			Estimated 1983	Baseline Projection				
	1980	1981	1982		1984	1985	1986	1987	1988
In Billions of Dollars									
Individual Income	244.1	285.9	298.1	285.8	294.9	320.8	345.8	371.6	400.0
Corporate Income	64.6	61.1	49.2	40.3	55.8	65.2	74.0	83.1	87.7
Social Insurance	157.8	182.7	201.1	212.1	232.1	258.2	283.2	303.4	326.2
Excise	24.3	40.8	36.3	37.7	41.6	41.5	36.4	35.5	35.9
Estate and Gift	6.4	6.8	8.0	6.1	5.9	5.6	5.0	4.6	4.3
Other	<u>19.9</u>	<u>21.9</u>	<u>25.0</u>	<u>24.1</u>	<u>23.0</u>	<u>23.6</u>	<u>23.8</u>	<u>23.8</u>	<u>24.1</u>
Total	517.1	599.3	617.8	606.2	653.4	714.9	768.3	821.9	878.2
As a Percent of Total Revenues									
Individual Income	47.2	47.7	48.3	47.2	45.1	44.9	45.0	45.2	45.6
Corporate Income	12.5	10.2	8.0	6.6	8.5	9.1	9.6	10.1	10.0
Social Insurance	30.5	30.5	32.6	35.0	35.5	36.1	36.9	36.9	37.1
Excise	4.7	6.8	5.9	6.2	6.4	5.8	4.7	4.3	4.1
Estate and Gift	1.2	1.1	1.3	1.0	0.9	0.8	0.7	0.6	0.5
Other	<u>3.9</u>	<u>3.7</u>	<u>4.0</u>	<u>4.0</u>	<u>3.5</u>	<u>3.3</u>	<u>3.1</u>	<u>2.9</u>	<u>2.7</u>
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
As a Percent of GNP									
Individual Income	9.5	10.0	9.8	8.9	8.4	8.4	8.3	8.3	8.3
Corporate Income	2.5	2.1	1.6	1.3	1.6	1.7	1.8	1.9	1.8
Social Insurance	6.1	6.4	6.6	6.6	6.6	6.8	6.8	6.8	6.8
Excise	0.9	1.4	1.2	1.2	1.2	1.1	0.9	0.8	0.7
Estate and Gift	0.2	0.2	0.3	0.2	0.2	0.1	0.1	0.1	0.1
Other	<u>0.8</u>	<u>0.8</u>	<u>0.8</u>	<u>0.8</u>	<u>0.7</u>	<u>0.6</u>	<u>0.6</u>	<u>0.5</u>	<u>0.5</u>
Total	20.1	20.9	20.4	19.0	18.7	18.7	18.5	18.4	18.3

machinery and equipment. Tax expenditures allocate federal resources in much the same way that spending programs do, and they add to the deficit. Thus, they can be analyzed for possible budget savings in the same way that spending programs are.

BUDGET HISTORY AND PROJECTIONS

The effects of the ERTA and TEFRA legislation dominate the budgetary story in the 1980-1988 period. ERTA is projected to reduce tax collections as a percentage of GNP by 3.9 percentage points below what they would otherwise be in 1984, and 5.6 points in 1988. This effect is only partially offset by TEFRA, which increases projected revenues by 1.1 percent of GNP in 1984 and 1.2 percent in 1988 (see Table X-2). The projected net effect of the two acts is to reduce revenues from the 1981 high of 20.9 percent of GNP to an estimated 18.3 percent in 1988.

Recent History, 1980-1982

Federal revenues grew from \$517.1 billion in 1980 to \$599.3 billion in 1981 and \$617.8 billion in 1982. As a percentage of GNP, total revenues rose from 20.1 percent in 1980 to 20.9 percent in 1981 and then slipped to 20.4 percent in 1982 because of the \$38.4 billion 1982 tax reduction resulting from ERTA. As shown in Table X-2, \$28.9 billion of the 1982 reductions were in the individual income tax and \$9.2 billion in the corporate income tax. Tax expenditures were increased significantly in ERTA, which added 11 new tax expenditures and expanded 21 existing ones, while reducing only two. (See Table X-2 for the estimated revenue effects.)

The Current Situation

In the budget resolution for 1983, the Congress, facing large projected deficits for the current and coming years, required revenue increases totaling nearly \$100 billion for 1983-1985. This target was met in TEFRA, which restored about one-fourth of the total revenue reduction for 1983-1985 enacted the year before in ERTA. Approximately 44 percent of the 1983-1985 revenue increases in TEFRA were in the corporate income tax, restoring about 55 percent of the corporate income tax reductions enacted the year before for that period. With 13 provisions that lowered tax expenditures and only two that raised them, TEFRA also reversed the previous year's pattern in dealing with tax expenditures.

TABLE X-2. REVENUE EFFECTS OF THE ECONOMIC RECOVERY TAX ACT OF 1981
AND THE TAX EQUITY AND FISCAL RESPONSIBILITY ACT OF 1982,
BY REVENUE SOURCE (In billions of dollars)

Type of Tax	1982	1983	1984	1985	1986	1987	1988
ERTA							
Individual Income	-28.9	-68.0	-105.2	-126.5	-155.3	-181.7	-213.4
Corporate Income	-9.2	-17.2	-25.7	-34.5	-42.5	-45.1	-43.2
Social Insurance	0.4	0.4	0.4	0.4	0.4	0.5	0.5
Other	<u>-0.8</u>	<u>-3.0</u>	<u>-4.2</u>	<u>-6.0</u>	<u>-7.9</u>	<u>-9.5</u>	<u>-10.9</u>
Total	-38.4	-87.8	-134.8	-166.6	-205.2	-235.8	-267.0
Percent of GNP	1.3	2.7	3.9	4.4	5.0	5.3	5.6
TEFRA							
Individual Income	--	4.9	12.7	12.5	14.8	17.8	20.1
Corporate Income	--	7.4	16.3	19.2	26.2	31.6	31.0
Social Insurance	--	1.9	3.1	3.6	2.9	2.6	2.3
Other	--	<u>3.7</u>	<u>5.6</u>	<u>6.4</u>	<u>2.9</u>	<u>2.1</u>	<u>2.3</u>
Total	--	17.9	37.7	41.7	46.9	54.2	55.7
Percent of GNP	--	0.6	1.1	1.1	1.1	1.2	1.2

ADDENDUM--CHANGES IN TAX EXPENDITURES a/

ERTA							
Increases	-12.8	-28.5	-40.6	-51.7	-65.7	NA	NA
Reductions	1.2	2.2	0.3	0.2	0.2	NA	NA
TEFRA							
Increases	--	-0.2	-0.6	-0.6	-0.3	-0.1	NA
Reductions	--	4.0	11.9	15.9	23.6	29.5	NA

- a. The revenue effects of the changes in tax expenditures shown here are included in the overall effects of the acts shown above.

Revenues for 1983 are now estimated to be \$606.2 billion, 19.0 percent of GNP. The share of total revenues represented by individual and corporate incomes taxes is expected to drop somewhat from the 1982 level, while the social insurance share is expected to increase somewhat.

Baseline Projections, 1984-1988

Total federal revenues as a percentage of GNP are projected to continue dropping between 1984 and 1988, from 18.7 percent in 1984 to 18.3 percent in 1988. Revenues as a percent of GNP were as low as 17.7 percent in 1965, and were below 18.3 percent in five other years in the 1960s and 1970s. Individual income taxes are projected to remain essentially steady as a percentage of total revenues during the 1984-1988 period, while the corporate income tax share is projected to rise from 8.5 percent in 1984 to 10.0 percent by 1988. The social insurance share is projected to increase by 1.6 percentage points, from 35.5 percent in 1984 to 37.1 percent in 1988.

DEFICIT REDUCTION STRATEGIES

In view of the pressing need to reduce future deficits, while at the same time encouraging both near-term economic recovery and future growth, any tax increases in a budget reduction strategy should be designed with the following three goals (and cautions) in mind:

- o Reduce disposable consumer incomes only when the economy has begun to revive;
- o Provide a long-term source of revenues for the tax system (which cannot be accomplished by temporary measures, such as surtaxes); and
- o Minimize disincentives to work, save, and invest, and improve the allocation of investment resources.

Any tax measure that reduced consumer demand in the near-term could prolong the current recession. At the same time, tax policy must be predictable so that businesses and investors can plan with the least possible uncertainty. So any tax increases that are adopted should take effect only after the economy has begun to recover and grow again, but should be enacted early to give business planners notice of the new conditions and to signal financial markets that the deficit is being reduced. Of course, this strategy cannot obviate all risk that the mere knowledge of future tax increases might depress current consumption and slow the recovery.

The credibility of future tax increases as deficit-reducing measures may also turn on their form. A tax increase that would take effect only if certain contingencies were fulfilled may not be viewed as a reliable way of reducing future deficits. A tax increase enacted now, but scheduled to take effect only in the future, would probably be viewed as more credible, even though the Congress could decide to rescind it before it took effect. The likelihood of such a rescission might also depend somewhat on the form of the tax; a surtax might be easier to rescind than some more basic, structural, change in the tax code.

Tax policy considerations may also be an important concern in formulating budget reduction strategies. Revenue-increasing measures that are consistent with the three basic tax policy goals--equity, efficiency, and simplicity--are more likely to stand up under long-term scrutiny and, thereby, to yield the reliable long-term revenues needed to reduce projected future deficits. Also, the goal of economic efficiency, which is served when taxes have the least possible distortionary impact on economic decisions, is generally consistent with the goal of devising tax increases that minimize disincentives to work, save, and invest, and that improve the allocation of investment resources.

Though all proposals to increase taxes can be judged according to these economic, budgetary, and tax policy criteria, a look at tax increases in the context of how they could affect various groups of individuals and industries can also be useful. Tax increases can be part of an across-the-board strategy, in which relatively small increases per taxpayer are spread over a large number of taxpayers. Or they can be part of a targeted strategy, in which larger increases per taxpayer are concentrated more selectively on particular groups of individuals or economic sectors. In the discussion that follows, tax increase options are classified as either across-the-board or targeted. Each option is evaluated in terms of the economic, budgetary, and tax policy criteria described above.

ACROSS-THE-BOARD STRATEGIES

An across-the-board approach to increasing revenues may be one or a small number of policy steps that increase taxes for much or even most of the population. Such a broad strategy would have the advantage of spreading the pain of deficit reduction thinly, and thus reducing the number of people or groups likely to raise intense opposition. It also has the consequent disadvantage, of course, that many people have some reason to oppose the policy, even though each person's additional burden might be small. Another potential advantage of the across-the-board approach is that

one large policy step might be easier to achieve than several narrowly focused revenue-raising measures.

An across-the-board strategy could either build upon existing tax provisions (an "incremental" approach), or it could entail an entirely new or fundamentally restructured tax. An incremental approach--for example, an increase in scheduled individual income tax rates or the addition of a corporate minimum tax--would involve no major change in the existing tax structure. New taxes could include a value-added tax (VAT) or a personal consumption tax; or the individual income tax could be fundamentally redesigned.

This last alternative could involve several relatively large base-broadening steps. The total yield of the changes could be set to exceed the target revenue gain, and the excess revenue could then be returned through across-the-board income tax rate cuts. This approach has the advantage of offering some compensation, in the form of a rate reduction, to taxpayers who are affected by the individual revenue-raising steps; simply broadening the tax base and providing no compensating rate cuts would leave all affected taxpayers worse off. This broader-base lower-rate strategy thus might spread the pain even more widely and thinly than base broadening alone. It might also have the advantage of making the tax system more fair and of increasing the incentive for work, saving, and investment through the lower tax rates. On the other hand, it would involve more individual policy steps and therefore would be more complicated than a targeted approach; it would also adversely affect more people than a targeted approach (though part of the effect would be offset), and therefore might arouse more political opposition.

Table X-3 shows the estimated revenue effects of a number of across-the-board options.

Incremental Modifications of Existing Taxes

Repeal the Third-Year ERTA Tax Cut. One incremental step to raise revenues across the board would be to repeal the third installment of the individual income tax rate cuts provided in 1981 under ERTA. The legislation called for a 5 percent across-the-board cut in tax rates in October 1981, a further 10 percent in July 1982, and a final 10 percent in July 1983. Elimination of the last installment would increase revenues by \$30 billion in 1984 and \$40 billion in 1988. In effect, income tax revenues would be about 10 percent higher than now projected for 1984 and thereafter, because the tax rates would be cut by less than was planned. (The precise amount of the tax change is actually much more complicated,

TABLE X-3. ESTIMATED REVENUE GAINS FROM BROAD-BASED TAX INCREASES (In billions of dollars)

Options	1984	1985	1986	1987	1988	Cumulative Five-Year Increase
Repeal July 1, 1983 Rate Reduction <u>a/</u>	30	33	35	38	40	177
Cap Third-Year Tax Rate Cut at \$700	6	7	7	8	9	37
Repeal Indexing <u>a/</u>	--	6	17	28	40	90
Impose Limit on De- ductions and Credits	<u>b/</u>	<u>b/</u>	<u>b/</u>	<u>b/</u>	<u>b/</u>	<u>b/</u>
Impose 10 Percent Individual Income Tax Surtax <u>c/</u>	15	33	36	38	41	163
Impose 10 Percent Corporate Income Tax Surtax <u>d/</u>	4	8	9	10	11	42
Impose Corporate Minimum Tax	<u>b/</u>	<u>b/</u>	<u>b/</u>	<u>b/</u>	<u>b/</u>	<u>b/</u>
Impose Value- Added Tax	<u>b/</u>	<u>b/</u>	<u>b/</u>	<u>b/</u>	<u>b/</u>	<u>b/</u>
Replace Income Tax with Expen- diture Tax	<u>b/</u>	<u>b/</u>	<u>b/</u>	<u>b/</u>	<u>b/</u>	<u>b/</u>
Introduce Broad- Based Low-Rate Income Tax	<u>b/</u>	<u>b/</u>	<u>b/</u>	<u>b/</u>	<u>b/</u>	<u>b/</u>

SOURCE: Staff of the Joint Committee on Taxation (JCT) and Congressional Budget Office. Assumes January 1, 1984 effective dates.

- a. JCT estimate. CBO's estimate is about 10 percent higher because of different estimating techniques.
- b. Revenue gain depends on details of proposal.
- c. Calculated as a percent of tax liability (before credits) rather than as a percent of taxable income.
- d. Calculated as a percent of tax liability before investment tax credits.

in part because the scheduled tax withholding cut is due to occur in the middle of calendar year 1983).

Repeal of the third year of the tax cut could prolong the current recession or dampen any recovery. It would, however, substantially reduce projected future-year deficits, thus easing upward pressure on long-term interest rates. To the extent that high interest rates are impeding economic recovery, therefore, repeal of the third year of the tax cut could have some beneficial effect.

An equity problem could arise from repeal of the third-year cut. The highest tax rate of 50 percent would not change (though it would take effect at a somewhat lower income level); it was reduced, from 70 percent, effective January 1, 1982. That initial reduction of the highest rate provided high-income taxpayers with the greater part of their three-year tax cut immediately, while those with lower incomes have had to wait for the full phase-in to be completed. So if the last year of rate cuts were repealed, those with the very highest incomes would have received more of their originally planned three-year tax cut than would those with more modest incomes.

A Cap on the Third-Year Tax Cut. Many alternatives to a complete repeal of the third-year ERTA tax cut are possible. One is to cap the 1983 tax cut at some arbitrary dollar amount; a cap of about \$700 for joint tax returns (with an appropriate adjustment for single taxpayers) has been proposed by several Members of Congress. Under one simple variation of this proposal, all income below some given level would be taxed at the 1983 tax rates; for example, the level could be set for couples filing jointly at \$35,200 of taxable income, at which level the 1983 tax cut compared with the 1982 law would be \$699. The tax rates on income above that level would revert to those in the 1982 law, so no taxpayer would receive a tax cut greater than \$699. A cap could be set at any amount and could apply to 1983 or 1984 tax rates.

To some extent, such a cap would mitigate the criticism that total repeal of the third-year tax cut would take a large share of the full tax cut from average taxpayers; those who would lose the biggest share of their three-year tax cut under this cap proposal are those in the upper-middle-income range (above \$35,200 but below \$109,400 on 1983 joint returns) who fall short of the highest tax bracket. Another aspect of the cap proposal to consider is that it would introduce a large jump in tax rates at one particular income level. With the \$699 cap, for example, the marginal tax rate would jump from the 1983 level of 30 percent for income between \$29,900 and \$35,200 to the 1982 level of 39 percent for income between \$35,200 and \$45,800.

A cap on the third-year cut would recover far less revenue than would complete repeal, because the portion of that tax cut below \$700 per joint return would still be allowed; the revenue gain from a \$700 cap on the last 10 percent of the tax cut would be about \$6 billion in 1984 and \$9 billion in 1988. The economic effects would thus be much more modest than those of complete repeal. If significantly more revenue was to be raised, the marginal tax rates would have to be increased for taxable income below the \$35,200 level; only about 15 percent of all income is taxed at rates above that level, and so the potential yield of tax increases exclusively above that level is strictly limited. If it was considered desirable to prevent upper-income taxpayers from receiving any of the 1983 tax cut, the tax rates in the 30 to 50 percent brackets would have to be raised even further. To recover some of the 1982 tax cut for the very highest-income taxpayers, the maximum tax rate would have to be increased above the 50 percent level. Of course, any number of alternative tax rate changes could be formulated to raise additional revenues from any segment of the income scale.

Repeal of Indexing. An automatic rise (indexation) in the personal exemption and tax rate brackets is provided in ERTA, to be effective in calendar year 1985. Indexing is estimated to decrease federal revenues from individual income taxes by \$6 billion in fiscal year 1985 and \$40 billion in 1988.

Indexing has considerable appeal as a device to prevent the unlegislated increases in real individual income tax liabilities that result solely from the effects of inflation on the tax system (commonly called "bracket creep"). If the federal government is considered likely to be short of tax revenues in 1985 and thereafter, however, the revenue gain from repealing indexing might seem desirable both in its timing and its sensitivity to economic conditions. Repealing indexing would not increase taxes in 1983 and 1984, when the economic recovery is likely to be fragile. Rather, it would raise revenues in 1985 and later years, when the prospect of continuing large budget deficits even with economic recovery is potentially most dangerous. Further, repealing indexing would increase taxes relatively more if too-rapid economic growth led to a rekindling of inflation, and relatively less if the economy grew slowly with little inflation. Repealing indexing now, rather than in 1984 or 1985, would give the financial markets advance notice of initiatives to reduce budget deficits, and thus might lead to lower interest rates.

If repeal of indexing were thought undesirable, postponement of the effective date from 1985 to 1986 could be an alternative. In effect, postponement would allow the real tax cuts due to ERTA--which are now larger than anticipated before the slowdown of inflation--to be somewhat eroded by future inflation until they reach a scale more like that originally

anticipated. A one-year postponement of indexing would push the revenue losses due to inflation further into the future, saving \$6 billion in 1985 and about \$10 billion in 1986.

The projected tax increases from bracket creep are now only about half as large as they were anticipated to be in 1981 when ERTA was enacted. The accumulated bracket creep in 1985, starting from October 1, 1981 (the effective date of the first installment of the ERTA tax cut), is now estimated to be \$47 billion, for example, \$42 billion less than it was projected to be when ERTA was enacted (see Table X-4). The real ERTA tax cut is therefore substantially larger than it was originally expected to be. As a result, a case could be made that indexing of the brackets and exemptions is needed less urgently than was originally thought. (It can be argued that ERTA must also compensate for the cumulative bracket creep since January 1, 1979, when the last tax cut before ERTA took effect. From that perspective, as Table X-4 shows, the amount of bracket creep tax increase for which ERTA must compensate is much larger; but the slowdown of inflation still makes indexing less urgently needed than if prices were rising faster.)

A possible drawback to the repeal or postponement of indexing is its relative effects on taxpayers at the low and high ends of the income spectrum. Compared with indexation of the exemptions and the tax rate brackets, the three-year tax rate cuts under ERTA were more generous to upper-income taxpayers and less generous to those with lower incomes. If indexing were repealed, one might argue that taxpayers with lower incomes would continue to be less than fully compensated for the bracket creep caused by inflation since the late 1970s.

Indexing can also be justified as a way of continuing the pressure for discipline in federal spending and tax policy. It assures that real individual income tax revenues increase at roughly the rate of growth in real incomes, thus requiring that spending increases be similarly limited if future deficits are not to increase. It also limits the opportunities for increases in tax expenditures and other special-purpose tax provisions and imposes pressure to reduce those that now exist.

A Limit on Tax Deductions and Credits. A somewhat less broadly based incremental approach to raising revenues would be some form of limit on all itemized deductions and tax credits. Such an approach would affect fewer taxpayers than would a rate increase, because only about 31 percent of all tax filers now claim itemized deductions, and only about 21 percent claim any tax credits.

TABLE X-4. REVENUE EFFECTS OF TAX CUTS UNDER ECONOMIC RECOVERY TAX ACT OF 1981 COMPARED WITH INFLATION-INDUCED INCOME TAX INCREASES (In billions of dollars)

	1983	1984	1985	1986	1987	1988
Economic Recovery Tax Act						
Individual Income Tax						
Rate Reductions	60	91	102	114	124	138
Indexing <u>a/</u>	--	--	8	19	32	45
Estimated Income Tax						
Increases from Bracket						
Creep, Current Inflation						
Assumptions <u>b/</u>	18	31	47	64	80	101
Reduction in Estimated						
Bracket Creep Since 1981 <u>c/</u>	24	35	42	52	NA	NA
ADDENDUM						
Additional Income Tax						
Increases from Bracket						
Creep Beginning January 1,						
1979, Current Inflation						
Assumptions <u>d/</u>	63	68	73	80	86	92

SOURCE: Congressional Budget Office.

a. This estimate differs from the JCT estimate for repeal of indexing in Table X-3 because of different estimating techniques and interaction between indexing and other individual income tax provisions.

b. Estimated by calculating the difference between the income tax revenues that would be collected in the absence of the Economic Recovery Tax Act, and those that would be collected if the income tax were indexed for inflation beginning in October 1, 1981. Assumes calendar year increases in the Consumer Price Index of the following amounts:

<u>1983</u>	<u>1984</u>	<u>1985</u>	<u>1986</u>	<u>1987</u>	<u>1988</u>
3.0	3.2	3.3	3.5	3.6	3.7

c. CBO, Baseline Budget Projections: Fiscal Years 1982-1986, July 1981 assumed calendar year increases in the CPI of the following amounts:

<u>1983</u>	<u>1984</u>	<u>1985</u>	<u>1986</u>
6.2	5.5	4.7	4.2

d. Shows additional effect of bracket creep measured from effective date of last pre-ERTA income tax reduction. If it is thought that ERTA should also compensate for this bracket creep, these numbers should be added to the post-October 1981 bracket creep shown above.